

# Moldova – Grabbers’ Heaven Or the Importance of the Quality of Institutions in an Aid Recipient Country



Department of Economics

UNIVERSITETET I OSLO

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Author:  
Ina Minascurta

Supervisor:  
Tone Ognedal

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# Summary

This work is aimed to demonstrate that in poor countries with bad institutions, foreign aid may lead to a resource curse. Foreign aid which is aimed to bring growth and prosperity to the recipient countries in the majority of cases fails to fulfill its main tasks. Many empirical, cross-countries and theoretical models show that the quality of institutions plays an important role in the economic growth of the country. Good, sound institutions lead to a sustainable economic growth with or without a "BIG Push", while bad, "grabber-friendly" as defined by Halvor Mehlum, institutions are biggest barriers for aid recipient countries to achieve sustainable development and prosperity for their people. Moldova – as an aid recipient country, is a good example of a country with "grabber-friendly" institutions which allowed rent-seekers to steal almost 1 billion USD, which constitutes almost 12% of Moldova's GDP and still be among Moldova's political elite.

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# INTRODUCTION

Resource curse is the phenomenon that countries with abundant natural resources do not perform as well economically as those without. Many economists draw a parallel between the effect of finding natural resources and the effect of getting foreign aid on economic development. The reason why natural resource wealth may lead to poor political and economic outcomes is that public institutions manage to fulfill their task of distributing the revenues in a fair and efficient way. In this thesis, I discuss how foreign aid may lead to a resource curse in countries with bad or weak institutions

Tim Hartford (2015) sums up the possible harms from resource abundance: “first, the revenue from resources creates volatility in government revenues that, if poorly managed, will lead to inflation and boom-and-bust cycles in government spending. Second, it produces foreign currency earnings that, if not neutralized by monetary policy, will raise the real exchange rate, undermining the competitiveness of other sectors. Third, they can damage institutions, including governance and the legal system indirectly, by removing incentives to reform, improve infrastructure, or even establish a well-functioning tax bureaucracy, provoking a fight to control resource rents” (Tim Harford, *Aid and the Resource Curse*, 2015). This work is aimed to demonstrate that in poor countries with bad institutions, aid may lead to a resource curse. In the first section, I explain the resource curse and give a brief review on the literature.

Next, I present a theoretical model of the resource curse, which will form the basis for the reasoning on aid and resource curse. A main result is that whether resources are a blessing or a curse depends on the political institutions of the country.

In the third section, I discuss how aid may lead to similar resource curse problems as rents from natural resources. Present and discuss the literature on aid and the resource curse.

In the fourth section, I briefly compare how differences the effect of exogenous resources depends on institutional quality in four countries: Norway and Botswana – with high institutional quality – are compared with Zimbabwe and Moldova – with low institutional quality.

My main contribution is to investigate the potential resource curse from foreign aid in Moldova. In the last section I give evidence for bad institutional quality in Moldova. One crucial piece of evidence is the incredible disappearance of 1 billion dollar from the 3 largest banks in Moldova – amounting to 12 percent of Moldova's GDP.

# 1. Resource curse

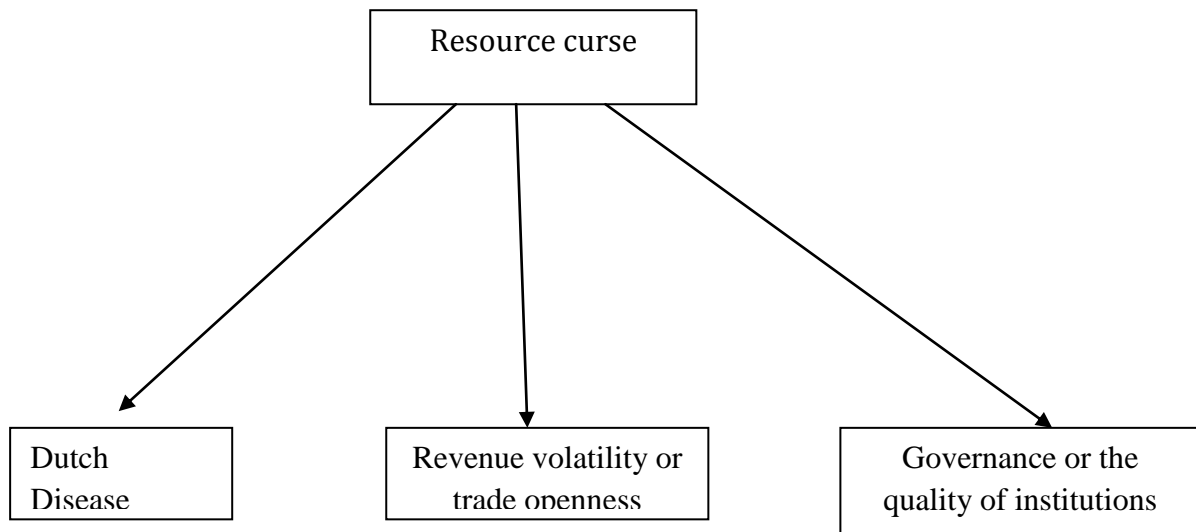
## 1.1. What is a resource curse?

One of the definitions of a resource curse is that it is “ the paradox that countries with abundance of natural resources, specifically point-source non-renewable like minerals and fuels, tend to have less economic growth and worth development outcomes that countries with fewer natural resources.” (Wikipedia)

The paradox is that not only may resource-rich countries fail to benefit from precious resources, but they actually perform worse than countries which are not blessed with natural resources.

The curse theory emerged in the 1990s with pioneering contributions by Sachs & Warner (1995). The term resource curse was first used by Richard Auty in 1993. He theorized that having certain natural resources including oil actually curses a country. Richard Auty studied and tried to explain negative relationship between natural resource wealth and economic growth. He showed that a resource boom affects the rest of the economy through two channels: the resource movement effect and the spending effect. A discovery of natural resources raises the value of the marginal product of labour in the resource sector and pushes the equilibrium wage rate up, leading to a movement of labour from both the manufacturing and non-tradable sectors to the resources sector. A boom in the natural resource sector leads to increased income for the country, and as a result increases domestic import of both tradable and non-tradable goods and services, while export in other branches of economy falls.

R. Auty explanations of resource curse fall into three main categories: Dutch Disease, trade openness and governance or the quality of institutions.



Dutch disease models explain a negative impact of natural resources as follows. Natural resource booms increase real wages and appreciate the real exchange rate, this lowers the competitiveness and production of the other sectors of the economy. Larger export revenues from natural resources cause the real exchange rate to appreciate.

This is a consequence of either the local currency appreciation against other currencies, or the increase in the local price levels, or both. This makes local manufactures or agriculture more expensive in foreign-currency terms, and so they lose competitiveness and lose its value for the economy. Much higher salaries in the resource dominant sector also attract the best skills and talent out of other sectors, out of government, and out of civil society. Overall, the booming natural resource sector ‘crowds out’ or wither these other sectors of the economy.

A second standard explanation for the Resource Curse is revenue volatility. Booms and busts in world commodity prices and revenues can destabilize the economies of countries that depend on natural resources export.

The third category for explaining the Resource Curse – the one I will focus on – falls under the headline ‘governance or the quality of institutions and rent-seeking. Rent-seeking can be one of the main causes of declining economic growth and can also lead the country into

poverty and class differences in the society. It is not the resource by itself that is the reason for the curse, but how the income from this resource is distributed and used. If natural resources are used as a source for rent-seeking and self - enrichment then it is a curse, but if resources are used as tool to secure another economic branches, then the whole economy can gain by accumulating additional capital which can be use for further economic development.

## 1.2. **Rent seeking.**

This work is aimed to investigate and demonstrate the resource curse from rent-seeking and this is what I will focus on. Rent-seeking is a concept used to describe the activities aimed to obtain or maintain wealth, primary with the help of state. By other words, instead of making a productive contribution to an economy, a rent – seeker obtain benefits for themselves by manipulating the countries policies, rules, political and economical environment. Easy, unearned money from resource fairy tale leads to conflict between people and government. Large amounts of resources and money are attractive for a country's government who use them for their own luxuries rather than for the people. Easy money leads to internal conflict which occurs within societies, as different groups and factions fight for their share of the cake. This leads to limited ability of government institutions to function effectively; to conflict between different government ministries and departments for access to resource money. “Easy money” from resource “fairy tale” may also lead to both internal and international war and conflict. The term” petro-aggression” has been used to describe the tendency of oil –rich states to instigate international conflicts or to be the target of a conflict. When easy rents are available, rulers lose interest in the difficult challenges of state-building, or the need for a skilled, educated workforce, and instead spend their energies competing with each other for access to a slice of the natural resource ‘cake’.

Weak state institutions, which are not able to distribute the income from natural resources correctly, can also lead to corruption. The corrupted government is less interested in building the institutional infrastructure to regulate and tax a productive economy, because a well-functioning institutional infrastructure might not allow the corrupted government to misuse the profit from natural resources.

### 1.3. **Can foreign aid give a resource curse?**

Might aid also give a resource curse just like natural resources do? Foreign aid provides a windfall of resources to recipient country and may result in the same rent seeking behaviour as documented in the Resource Curse literature. Many countries in the World are aid receivers without any significant improvement in their social and economical situation. For example, Burkina Faso, foreign aid accounts for two-thirds of the government budget and (% of GDP over the period 1985-89. In Mauritania, it accounted for 60% and 22%, respectively, for the period 1980-84. In Rwanda, Vanuatu, Gambia, Niger, Tonga and Mali, foreign donors provided over a third of the government budget during some 5-year periods between 1960-1999. Some countries are totally depended on foreign aid. Aid accounted for 40% of the government budget and 6.2 of GDP in Burkina Faso during 1960-1999. In Mauritania, for 37% and 12% respectively.

Some analysts argue that aid can slow growth by increasing the value of the local currency, which makes the manufacturing sector less competitive. Other argues that aid may reduce tax revenue mobilization and that the conditions imposed by donors may lead to excessive concentration of talented and skilled working force in aid administration.

Several investigations have show that some aid money goes missing before reaching the actual recipients, and this money may as well have the same characteristics as those of natural resource revenue.

In his article “what can we learn about the “Resource Curse ” from Foreign Aid, 2010” Kevin M. Morrison draws a parallel between resource aid and foreign aid, arguing that the Curse is in the “ function of the institutional environment in which these resources are found and how the revenues are used.”

A recent empirical literature has investigated the role of institutions on development. Mauro (1995, 1998), Knack and Keefer (1999), Hall and Jones (1999), Acemoglu et al. (2001,2002), Easterly and Levine (2003), Dollar and Kraay (2003) and Rodrik(2004), Mehlum, Moene and Torvik (2006) among others, show a positive relationship between good institutions and development.

In next section. I present the theoretical model of Mehlum, Moene and Torvik (2006) in more details, to show what are the relationship between economic growth and the quality of state's institutions.

## 2. A Theoretical Model of the resource curse

In this section I present a theoretical model by Mehlum, Moene and Torvik (2006), investigating the relation between institutions and the resource curse. In this model, entrepreneurs can either be producers or rent seekers (grabbers). The equilibrium allocation of entrepreneurs between production and grabbing is determined by revenue that they can earn from the two activities. Which activity is more profitable depends on the quality of institutions or the “rule of law”. This gives two types of equilibrium in the model. When institutional quality is high we have a “producer’s equilibrium”. When the institutional quality is low, the equilibrium is a ‘grabber equilibrium’, where some entrepreneurs are producers and some are grabbers. More natural resources are a “blessing in production equilibrium”, while more natural resources are a “curse in a grabber equilibrium”.

The total number of entrepreneurs is denoted by  $N = n_P + n_G$ , where  $n_P$  are producers while  $n_G$  are grabbers. Grabbers are interested in rents from natural resources  $R$  and use all their capacity to earn as much as possible of this rent. The quality of the institutions determines how much of the rent they can grab. In the model the institutional quality is captured by the parameter  $\lambda$ , which goes from 0 (bad quality institutions) to 1 (good quality institutions). When  $\lambda = 0$ , the system is completely grabber friendly such that grabbers extract the entire rent, each of them obtaining  $R/n_G$ . A higher  $\lambda$  implies a more producer friendly institutions. When  $\lambda = 1$ , there are no gains from specialisation in grabbing as both grabbers and producers each obtain the share  $R/N$  of resources. Thus,  $1/\lambda$  is a measure of the degree to which an entrepreneur gains if they decide to pursue grabbing activities. In countries where  $\lambda$  is low, this relative gain from grabbing is large.

In the model, grabbing and production are competing activities. In countries where  $\lambda$  is high, grabbing and production may become complementary. The higher is  $\lambda$ , the lower is the gain from grabbing and the less producers would like to switch from production to become grabbers.



The pay-off  $\pi_G$  to each grabber is a factor  $s$  times  $R/N$

$$\pi_G = sR/N \quad (1)$$

while each producer's share of the resource rent is  $\lambda sR/N$ . The factor  $s$  is decreasing in  $\lambda$  since each grabber gets less the more producer-friendly the institutions. As the value of  $\lambda$  goes up from zero to one, profits for grabbers goes down. Grabbers therefore prefer bad institutions. There is also a positive effect on  $s$  from less competition between grabbers. Hence, the value of  $s$  is an increasing function of the fraction of producers  $\alpha = n_P/N$  and a decreasing function of the institutional parameter  $\lambda$ .

The payoff for grabbers is also increasing in the fraction of producers,  $\alpha$ . The reason is that an increase in the number of producers reduces competition for rents. The sum of shares of the resource rent that accrue to each group of entrepreneurs cannot exceed one. Hence, the following constraint must hold:

$$(1 - \alpha)s + \alpha\lambda s \leq 1. \quad (2)$$

The rent seeking factor  $s = S(\alpha, \lambda)$ , captures the relationship between quality of institutions  $\lambda$ , fraction of producers  $\alpha = n_P/N$  and grabbers  $(1 - \alpha)$ . The factor  $s$  declines in the quality of institutions  $\lambda$  and increases in the size of producers  $\alpha$ .

$$s = s(\alpha, \lambda) \equiv \frac{1}{(1 - \alpha) + \lambda\alpha}. \quad (3)$$

The profits of a producer  $\pi_P$  is the sum of profits from production  $\pi$  and the share of the resource rents  $\lambda sR/N$ . Thus,

$$\pi_P = \pi + \lambda s(\alpha, \lambda)R/N. \quad (4)$$

Producers' payoff is higher as the quality of institutions is better, or when value of  $\lambda$  *increases*. Good institutions give them the possibility to get a larger share of the resource rent.

We can show that  $\pi(n_P)$  is everywhere positive and increasing in the number of producers  $n_P = \alpha N$ . The total profits to each producer then are

$$\pi_P = \pi(\alpha N) + \lambda s(\alpha, \lambda) R/N. \quad (5)$$

By rearranging the pay-off for each grabber, equation  $\pi_G = sR/N$  we get

$$\pi_P = \pi(\alpha N) + \lambda \pi_G. \quad (6)$$

Entrepreneurs' decision to whether get involved in grabbing or in productions, is determined by the profits entrepreneurs can get from two activities. Both profit functions  $\pi_G$  and  $\pi_P$  are increasing in the fraction of producers  $\alpha$ . This is illustrated in [Figure 1](#), where the dashed curve represents a lower  $\pi_G$ -curve. The  $\pi_G$ -curve is high relative to the  $\pi_P$ -curve if the institutional quality  $\lambda$  is low, the resource rent  $R$  is high, or the number of entrepreneurs is low. In order to achieve a stable share of producers and grabbers over a period of time, the profits must be equal in both activities

$$\pi_P = \pi_G \quad (7)$$

In equilibrium, point  $b$ , in [Figure 2.1.](#), where the profit from grabbing equals to the profit from production there is no gain to any entrepreneur from switching activities from grabbing to production or vice verse.

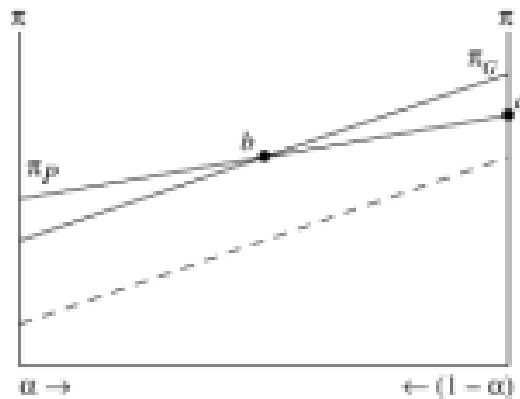


Figure 2.1. Resources and Rent Seeking

As a result the economy may end up in one of the following two types of equilibrium:

Production equilibrium, where all entrepreneurs are producers ( $\pi_P \geq \pi_G$  and  $\alpha = 1$ ).

Grabber equilibrium, where some entrepreneurs are producers and some are grabbers. When the quality of institutions is high, the equilibrium is a production equilibrium and when institutional quality is low, the equilibrium is a grabber equilibrium.

In the production equilibrium more natural resources is a pure blessing, a higher  $R$  raises the whole national income. While more natural resources in grabber equilibrium is a curse, a higher  $R$  lowers national income.

“The result that more resources reduce total income may seem paradoxical. There are two opposing effects: “the immediate income effect” of a higher resource rent  $R$  is a one to one increase in national income; “the displacement effect” reduces national income as entrepreneurs move from production to grabbing. The resource curse follows as the displacement effect is stronger than the immediate income effect. An entrepreneur who moves out of production forgoes the profit from modern production  $\pi(n_P)$ , but obtains an additional share of the resource rent equal to  $(1 - \lambda)sR/N$ . “

“In equilibrium both these two values are equal. With more natural resources the additional resource rents to grabbers obviously go up. Producers then prefer to switch to grabbing until a new equilibrium is reached. It is a well-known result from the rent-seeking literature that a fixed opportunity cost of grabbing implies that a marginal rise in rents is entirely dissipated by more grabbing activities. Hence, in these models the displacement effect exactly balances the immediate income effect. In our case, however, the positive externality between producers implies that the opportunity cost of grabbing declines as entrepreneurs switch from production to grabbing. The declining opportunity cost magnifies the displacement effect and explains why the displacement effect eventually is stronger than the immediate income effect.”

Figure 2.2. below illustrates what happens as a country gets a higher resource rent,  $R$ .

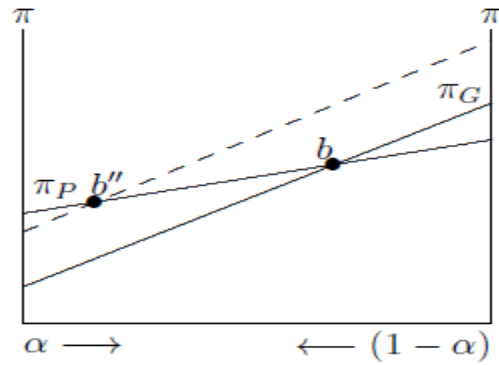


Figure 2.2. Rent seeking in the case of a higher resource rent,  $R$

The discovery of oil, diamonds or foreign aid presents a new source of income in the economy. Which profit curve will be shifted upwards depends on the quality of institutions. An increase in  $R$  is shared between the two groups producers and grabber. The grabbers get a larger portion of  $R$  if the quality of institutions is low. A low value of  $\lambda$  results in an upward shift of the grabbers profit function. The dashed line in the diagram shows completely grabber friendly institutions with  $\lambda = 0$ , causing an entire shift in the grabbers profit curve accompanied by no change in the producers profit curve. Assuming free entry into grabbing,  $\pi_g > \pi_p$  leads to a new equilibrium  $b''$ . This is characterized by a flow of producers into grabbing in search of higher profits. The overall effect of this movement is to drive profits all the way down to equilibrium  $b''$ . Equilibrium  $b''$  has lower profits, very few producers and an increased number of grabbers (Figure 2.2).

Mehlum, Moene and Torvik (2006) conclude that “countries rich in natural resources constitute both growth losers and growth winners. They states that quality of institutions determines whether countries avoid the resource curse or not. The combination of grabber friendly institutions and resource abundance leads to low growth. Producer friendly institutions, however, help countries to take full advantage of their natural resources.”

## 3. Foreign aid

### 3.1. Literature review

The literature on the impact of aid on sustainable growth is controversial, with statements and counter-statements about aid effectiveness. A number of studies (Easterly (2003), Easterly, Levine, and Roodman (2004), Hansen and Tarp (2001), Roodman (2004), and Rajan and Subramanian (2005) suggest that even in countries with good policies, there is no strong relationship between aid and growth. These recent studies suggest that corruption and mismanagement cannot be the only reasons why aid does not lead to growth. Even if certain kinds of aid may have some positive results in the short run (see Clemens, Radelet, and Bhavnani, (2004)), the effects are not significant in the longer run. This suggests that while some aid does reach the recipient and is actually spent on original goals, goals that lead to short run growth, it is still an open question why aid does not have strong and sustainable long run effects on growth.

International foreign aid is an economic aid which is voluntary provided to the countries, provinces or groups of people within a country, which are in humanitarian crisis.

Humanitarian aid is a short term help in an emergency situation. Development aid is more a long term aid. Development aid is aimed mostly to reduce poverty and obtain economic and social growth in the recipient country. Foreign aid is a source for additional capital into the country's economy and has some of the same characteristics as natural resource abundance. Both can be a "Big Push" to an economy if they are distributed and managed wise. However, both can also be attractive for politicians to avoid unpopular methods of income accumulation like taxation.

Originally foreign aid should work as help to self-support or to provide a "Big Push" to the country's economy ( Murphy, K., Shleifer, A., Vishny, R., 1986), by providing capital to increase investments, so that countries could avoid the poverty trap (Hagen, 2007). Foreign aid should finance investment gap between national savings and required investment level to achieve economic growth. The poverty trap can be illustrated by a Solow growth model, as shown in Weil ( 2005). His model is based on the idea that a poor country does not have enough capital. As a consequence the savings level is low and investments are low, and so the

country remains poor. An increase in the capital through foreign aid can push the economy out of this poverty trap. As soon as a recipient country achieves economic growth and becomes economically independent, it no longer needs foreign aid.

Different theories give different interpretations of foreign aid. The realist theory focuses on aid as an instrument of diplomacy. Given its initial assumption of states behaving in an anarchic environment, the realists see foreign aid as an instrument used to ensure state security, protection of its political and economic interests. Therefore, taking into consideration that aid in this case is given primarily to benefit the donor, its capability to achieve development is limited.

The Marxists school of thought and postmodern tradition sees foreign aid through a dependency relationship between a group of wealthy capital rich core and poor periphery countries. The rich countries use their position of dominance to control and exploit the resources of the poor countries, tying aid to policies, services and goods for gaining access to markets and resources.

The liberal strand of thought concentrates on its economic dimension, in particular the effectiveness of development cooperation to address the problems of globalization and interdependency such as environmental, health etc.

The constructivist theory interprets foreign aid as guided by normative principles, ideas of humanity about the moral obligation of more affluent countries to help the poorer. Only in these conditions an international order could prosper, when it is based on generosity and readiness to cooperate in the interest of humanity (Lancaster 2007, pp. 3-4).

Recently, the debate in the literature about foreign aid is divided in two parts. One examines the purposes of foreign aid and the other examines the effectiveness of aid to achieve development. The second is the one most relevant for the resource curse problem.

Studies of the effects of aid on growth and poverty reduction show mixed results. I will first discuss the studies that find a positive relation and then the ones that show a negative relation.

### **3.2. Positive foreign aid-development relationships.**

The past 30 years have witnessed the publication of a large number of studies on aid effectiveness. The methods used to study foreign aid range from detailed case studies at the project level to regression analyses of the growth impact of aid in samples of almost a hundred countries.

For example empirical analysis of Burnside and Dollar (1997, 2000) show evidence of threshold effects by the introduction of an aid-policy interaction term in the growth regressions. In their model, they investigated a new hypothesis that foreign aid does affect growth, but that its impact is conditional. It contributes positively to growth, but only in good policy environments.

Similarly, empirical analysis by Radelet (2006) finds that the most important determinants of growth are foreign policy and political relationships. He states that "the view that aid works in countries with good policies and institutions has become the conventional wisdom among donors". Donors have a variety of motives to give aid and only some of them are related to development. The bilateral aid is designed at least partially to serve the economic interests of the donor countries (for example tied aid - to support certain objectives that support specific groups in donor's countries). Multilateral is less biased in this respect, although, it cannot be judged immune to influences. However, overall, donors provide most of the concessional aid to poorest countries. There was no simple relationship between aid and growth. Some countries which received aid grew, others have had recorded slow or even negative results. Generally, aid has a positive relationship with growth across countries, but not in each country and presents diminishing results as the volume increases (Radelet 2006, pp. 6-8).

Hansen and Tarp (2000) provide a survey of empirical analyses from the last 30 years that make use of cross-country regressions in assessing the effectiveness of foreign aid. From 131 such regressions, a reasonably consistent pattern emerges. First, that aid increases aggregate saving; second, aid increases investment, and third, aid has a positive effect on the growth rate whenever growth is driven by capital accumulation.

Estimation of the cross-country relationship between foreign aid receipts and economic growth by Clemens et al (2011) points out that the effects of aid are positive across countries on average, but are limited in comparison with other factors of growth. Clements et al(2011) re-analyse data from the three most influential published aid–growth studies of Boone, Burnside & Dollar and Rajan & Subramanian. All three research designs show that increases in aid have been followed on average by increases in investment and growth. The most plausible explanation is that aid causes some degree of growth in recipient countries, although the magnitude of this relationship is modest, varies greatly across recipients and diminishes at high levels.

To sum up, aid seems to have the potential for creating growth, but given in the wrong way or given to countries which cannot handle it efficiently, it may even be negative. This is the main point of this thesis.

### **3.3. Negative foreign aid – development relationship.**

One of the most ardent critics of aid Dambisa Moyo, a Zambian-born international economist and author who analyzes the macroeconomy and global affairs argues (Moyo 2009) that foreign aid given to elites encourage rent seeking behaviour, hinder reforms and spurs corruption. It interferes in the rule of law, the work of institutions and deteriorates the respect of civil rights which makes country unattractive for domestic and foreign investments. Fewer investments reduce growth and increase poverty levels and given the pressure to lend, donors allocate more aid which is diverted, so that the process is continuing in the same vicious circle. It establishes a dependency, encourages corruption which has repercussions for growth and perpetuates underdevelopment (Moyo 2009, p. 49 ).

In standard neo-classical growth models Boone (1994, 1996) shows that aid has no impact on investment or growth. The result was substantiated by panel data regressions based on a sample of more than 90 countries over the twenty years. Based on his regression he concludes that "aid programs have not ... engendered or correlated with the basic ingredients that cause ... growth." Boone's empirical results have later been questioned.



Empirical studies by Hadjimichael et al.(1995), Durberry et al. (1998), Lensink and White (1999), and Burnside and Dollar (2000) are all based on fairly standard cross-country growth relations, modified to analyse the effectiveness of aid by adding foreign aid as a fraction of GDP. These studies have a lot in common, including overlap in samples and estimation methods; and in contrast to Boone (1994), they all find a positive impact of aid on growth.

On the other hand, empirical study of Doucouliagos and Paldam (2011). find that “aggregate aid has no robust effect on growth, on average.” They states that foreign aid has no significant importance, as on average, aggregate development and aid flows are ineffective to generate growth.

Bauer and Yamey (1982) affirms that foreign aid is likely to hinder development. This is because the economic results depend on the conduct of people and their governments’ efforts and the slow progress of these societies cannot be overcome by foreign aid, but rather will reinforce it. They argue that foreign aid’s “monopoly on compassion”, so that nobody can criticize these transfers of resources as ineffective or damaging, allows them to claim that poor results are due to insufficiency of aid. During decades, sufficient amounts have flowed towards recipient governments which did not performed well and created perverse incentives. The access to aid of recipients has absolved them from the necessity to create necessary conditions for external inflows of capital. The tax revenues are kept low, because of availability of aid money extends the power of the existing political status quo and their control over the society which results in its politicization. It inhibits private enterprise and therefore the inflow of foreign investments, creates overvalued exchange rates, increases domestic money supply and inflation, balance of payments difficulties and produces deficient fiscal policies.

Foreign aid also creates perverse incentives such as pauperization of the countries in order to be eligible for aid, de-skilling and increases of dependency of these societies on donors (Bauer and Yamey 1982, pp. 302-310). Moreover, the work of Djankov et al (2006) concludes that foreign aid has a negative impact on economic growth and democratic achievements of developing countries, because it reduces investment and increases spending. The effectiveness of aid is affected by the type of aid disbursed grants or loans. Contrary to Sachs, who argues that more aid should be given as grants, they suggest that loans are a more effective measure to ensure the effectiveness of aid (p. 2). The argument is that if aid is given as loans, there are stronger incentives to use these resources efficiently. The recipient country will take

care to obtain a good return on the investment in order to pay back the loan. In the case of grants, these are mostly increasing public consumption. Their research has shown that increasing foreign aid has no effect on investment, but it has a significant effect on government consumption. Foreign aid has positive effects if the ratio of grants in aid is small enough (ibid., p. 17).

Historically, foreign aid has not influenced economic growth of the recipient country. Analysis done in the aid and growth regressions by the Burnside and Dollar, World Bank (2000) by researching 56 recipient countries shows that aid spurs growth conditional on the quality of institutions and that it does not show the same positive effect in all institutional environments. A long-term economic growth is possible in stable macroeconomic environments, open trade regimes, protected property rights, as well as efficient public bureaucracies that deliver education, health, and other public services. When a country have this kind of institutions both aid and revenue from natural resources has a big effect on growth and poverty reduction. Equally, aid has little effect on the development of countries with poor management.

These results are similar to the Mehlum's ones in the "Institutions and the Resource Curse", where foreign aid represents resources and economic policy represents institutions quality. In the countries with low political quality foreign aid does not have a significant influence on economic growth.

Mehlum et al (2006) focus on how the quality of institutions affects the decision of entrepreneurs that specialize in either rent seeking or production. The model looks at how the quality of institutions in countries that have just discovered precious minerals affects the incentives of entrepreneurs that specialize in rent seeking and production activities. In their model, entrepreneurs freely allocate themselves between rent seeking and productive activities as determined by the relative payoffs. The gains from each activity are determined by the quality of institutions, such as the rule of law, bureaucratic quality and corruption in government. When institutional quality is high, majority of entrepreneurs engage in productive activities. In this case, more natural resources result in higher total income. Poor institutions open opportunity for entrepreneurs into grabbing and due to negative externalities in rent seeking; more natural resources lower the aggregate income. Their model predicts that low institutional quality in resource abundant countries results in a resource curse, whereas good institutions lead to a blessing.

## **4. The role of institutions. Norway, Botswana, Zimbabwe and Moldova**

The question is: Why have some countries been able to manage their natural resources successfully, while others have failed to reap the potential benefits? Some potential answers can be identified by examining specific cases.

### **4.1. Botswana**

Since its independence from Britain in 1966, Botswana has become one of the success stories of developing countries. From being one of the twenty-five poorest countries in the world Botswana end up to be an upper-middle income country in 1998, and reached a per capita GDP of 9,200 USD in 2004. The impressive 13,9% GDP growth in the seventies has now declined to 3,5% in 2004, but Botswana's economy still remains one of the fastest growing economies in Africa.

Botswana was a foreign aid recipient and after discovering diamonds in 1967, it has also been a country rich in natural resources. Botswana has managed both aid and natural resources well. As a result, it has achieved development and has avoided the resource curse.

Botswana is regarded as a country with good governance and democratic public institutions. This is reflected in the Transparency International's Corruption Perceptions Index, where Botswana score 65 in 2012, 64 in 2013 and 63 in 2014 CPI index. Botswana is the least corrupt on the African continent, ranking well above some European countries such as Italy or Greece.

Figure 4.1. The Corruption Perception Index

## RESULTS: TABLE AND RANKINGS

The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be. A country or territory's score indicates the perceived level of public sector corruption on a scale of 0 (highly corrupt) to 100 (very clean). A country or territory's rank indicates its position relative to the other countries and territories in the index. This year's index includes 175 countries and territories. Click on the column headings to sort the results, or use the drop-down menu to view results by region. Note that N/A means a country was not included in the index during a particular year.

Sub-Saharan Africa				
RANK	COUNTRY	2014 SCORE	2013 SCORE	2012 SCORE
31	Botswana	63	64	65
40	South Africa	57	58	59

Source: International Transparency ([www.transparency.org](http://www.transparency.org))

It also invests a portion of its resource wealth in its Pula Fund, a long-term investment portfolio. Established in 1994, its purpose is to preserve a part of the income from diamond exports for future generations. Pula Fund serves as a buffer against price volatility. Foreign exchange reserves that are in excess of what is expected to be needed are transferred to Pula Fund and invested according to the needs.

Botswana has also set up mechanisms to ensure that a significant part of its mineral resource revenue is allocated for investment in health and education.

Botswana was reviewed by Transparency International, which is a global civil society organisation leading the fight against corruption. Transparency International is using a concept called country's National Integrity System (NIS), which is a "sum total of laws, institutions and practices in a country that maintain accountability and integrity of public, private and civil society organisations". Over the years, the NIS concept has come to be closely associated with the quality of institutions and practices that form an anti-corruption system. Botswana was reviewed in 2001 and several elements of the NIS point out that Botswana has developed strong good governance. Democracy is fully practiced in the country. Botswana's government is accountable to the people. Elections are held on a regular basis. The country operates a written constitution to which all organs of government are subjected. The rule of

law operates fully in the country and it has the right political and legal environment to fight corruption. There is also transparency at various levels of government.

Botswana is a source of inspiration for other developing nations that would like to avoid issues of the “resource curse”.

#### **4.2. Norway**

Another country which is one of the best examples in avoiding the resource curse and succeeding in economical development is Norway. Norway has drawn on its oil wealth to move from being one of the poorest countries in Europe during the early 1900s to lead UNDP’s global Human Development Index frequently in recent years.

After Phillips Petroleum discovered Ekofisk in 1971 (one of the world's largest offshore fields which expected to continue producing oil until 2050) Norway suddenly became officially rich with oil. At the same time occurred the risk of falling victim to the natural-resource curse. The Iraqi geologist Farouk al-Kasim who has been more responsible than anyone else for Norway’s success as an oil power.( FT Magazine, The Iraqi who saved Norway from oil, August 29, 2009.)

Al-Kasim was put in charge of mapping out how Norway would exploit its newly discovered oil resources. He did a remarkable job of connecting private-sector competitiveness with government control, and Norway seems to have avoided the “resource curse” that has dragged down the economies of many nations with natural resource abundance. Al-Kasim was concerned about "Dutch Disease," a phenomenon first seen in the Netherlands in the 1960s, when the Dutch economy unexpectedly suffered after a massive gas field was found in its part of the North Sea. He knew it would take a clear policy and careful planning to avoid a similar situation in Norway.

He studied other oil-exporting countries, and found that the biggest problem was a lack of planning and a clear strategy. Al-Kasim said that, 'Norway concluded that if you don't have a policy up front, and if you don't have a consensus on that policy, that human nature would tend to favour individual interests rather than coherent national interests’.

One radical solution aimed at preventing the oil money from destroying Norway's existing industries was to limit the amount of oil revenues the country used in the short term. To help reduce short term spending, oil revenues was put it in an oil trust fund which is now worth hundreds of billions of dollars. The government only spends the interest that the fund generates.

In 1971, shortly after the Ekofisk discovery, the Norwegian parliament drafted legislation that came to be known as the country's "10 Oil Commandments."

1. National supervision and control must be ensured for all operations on the Norwegian Continental Shelf (NCS).
2. Petroleum discoveries must be exploited in a way, which makes Norway as independent as possible of others for its supplies of crude oil.
3. New industry will be developed on the basis of petroleum.
4. The development of an oil industry must take necessary account of existing industrial activities and the protection of nature and the environment.
5. Flaring of exploitable gas on the NCS must not be accepted except during brief periods of testing.
6. Petroleum from the NCS must as a general rule be landed in Norway, except in those cases where socio-political considerations dictate a different solution.
7. The state must become involved at all appropriate levels and contribute to a coordination of Norwegian interests in Norway's petroleum industry as well as the creation of an integrated oil community which sets its sights both nationally and internationally.
8. A state oil company will be established which can look after the government's commercial interests and pursue appropriate collaboration with domestic and foreign oil interests.
9. A pattern of activities must be selected north of the 62nd parallel which reflects the special socio-political conditions prevailing in that part of the country.

10. Large Norwegian petroleum discoveries could present new tasks for Norway's foreign policy.

" These 10 Oil Commandments form the basic policy on which Norway has managed its petroleum resources ever since. To quote al-Kasim : "And the politicians not only agreed on this document, but they agreed not to debate it in elections and the third miracle ... that they kept their promise." This shows that public institutions function well in Norway, providing a good environment for economic growth and prosperity.

Norway and Botswana are two countries with good institutions and wise spending of resource incomes. Both countries have almost the same index of economic freedom, which lies above the world average and manage to avoid resource curse.

#### 4.3. **Zimbabwe**

Zimbabwe is a country endowed with significant amounts of natural resources, such as diamonds, but it still remains one of the poorest countries in the world. When it became independent in 1965, Zimbabwe had a diversified economy, well-developed infrastructure, and advanced financial sector. It is now one of Africa's poorest countries. In July 2013, President Robert Mugabe of the Zimbabwe African National Union-Patriotic Front (ZANU-PF) was re-elected to his seventh five-year term, and his party won three-quarters of the seats in parliament. After decades of corruption and mismanagement, Zimbabwe faces an economical crises. In 2014, poor harvest left 2.2 million people in need of food assistance.

In 2006, villagers in the Marange district of eastern Zimbabwe discovered one of the world's biggest diamond deposits. By some estimates, the Marange diamond fields could produce as much as 40 million carats a year—worth about \$2 billion, or over 10% of the global diamond supply.

Unfortunately, this diamond discovery was too tempting for Zimbabwe's authoritarian president, Robert Mugabe, to resist. In 2008, Mugabe sent his army to take over the control

over the diamond fields from unlicensed diamond miners. The Mugabe's army killed more than 200 people and buried them in mass graves.

After the takeover, the army ran mining operations itself. Local residents, including children, were forced to mine for diamonds in slave-like conditions. Killing, beatings, torture and sexual violence were all used by the army to keep local residents working and maintain a climate of fear. Here we can see how abundance in natural resources, in this case diamonds, easily leads to internal conflicts and wars. .

Instead of ending military involvement, the government gave military leaders part of the ownership in the companies overseeing mining activities. Smuggling, violence and other human rights abuses continued. In 2010, the Zimbabwean police was investigating and documented human rights abuses in the Marange diamond fields. The group of leaders were put in prison for five weeks. In October 2011, the BBC discovered how Zimbabwean soldiers brought diamond miners who failed to hand over earnings to a camp, and used torture, beatings, and rape to punish the miners.

In November 2011 Zimbabwe's export ban was lifted. Zimbabwe is now permitted to export its unethical diamonds with conflict free certification. The KP's decision was so controversial that it prompted Global Witness, one of the advocacy groups that founded the KP, to resign from the certification scheme in protest, calling it an "accomplice to diamond laundering."

Zimbabwe's failure to ensure that its diamonds are ethically mined affects all Zimbabweans. In 2012, the advocacy group Partnership Africa Canada estimated that \$2 billion in diamonds had been lost to smuggling, much of it disappearing into the hands of Mugabe insiders. The group called it the "biggest plunder of diamonds since Cecil Rhodes," the 19th century British imperialist who founded De Beers. It is also believed that Mugabe's political party, ZANU-PF, used stolen diamond revenues to fund a campaign of voter intimidation and ballot rigging that helped Mugabe, a despotic leader, rig a presidential election in 2013 and win a seventh presidential term

Tracking Zimbabwe's diamond revenues is already an impossible mission. Very little is made public. The National Budget Statement only focuses on non-tax revenue in the form of dividends and royalties, but does not give details of other diamond incomes, such as through tax. Furthermore, little is known about where the money goes. In 2012, despite having



been assured of minimum \$600 million in diamond dividends, the Finance Minister reported that just \$43 million had been delivered. At the end of 2013 a new Finance Minister announced that despite an expected \$61 million, not so much as a cent materialized. This year, the Treasury predicted \$96m, but failed even to report what it received.

Nearly three quarters of Zimbabwe's population are living below the poverty line. At the beginning of 2014 the Ministry of Public Service, Labour and Social Welfare reported that the Treasury had failed to allocate sufficient funds for vital food and education assistance. According to the Ministry more than 900,000 children were put at risk of missing school while upwards of 1.5m people's access to food was jeopardised.

Zimbabwe is endowed with significant amounts of natural resources but remains one of the poorest countries in the world. Zimbabwe's economic freedom score is 37.6, making its economy the 175<sup>th</sup> freest in the 2015 Index. Zimbabwe is ranked last out of 46 countries in Sub Saharan Africa, and its overall score remains far below the world and regional averages. While political elite lives like a rock star in USA, France and has a multimillion dollars estate and luxury cars and speedboats collections, the majority of Zimbabweans citizens live in "grinding poverty". About 8 in 10 of those eligible to work are jobless. Citizens spend hours in darkness, because the economy cannot provide their energy requirement. Infrastructure is poor and companies are closing, unemployment is increasing. Diamonds are being illegally exported and revenue from illegal diamonds export lies in the pockets of political elites and their networks. Corruption remains endemic. Civil servants may make unpredictable demands for unofficial payments for variety of "services". Zimbabwe reform program, characterized by chaos and violence, badly damaged commercial farming.

#### **4.4. Moldova**

Moldova's economic freedom score is not so different from Zimbabwean. It score 57.5, making its economy the 111<sup>th</sup> freest in the 2015 Index, Moldova is ranked 39<sup>th</sup> among 43 countries in the Europe region, and its overall score is below the regional and world averages. If we compare Moldavian and Zimbabwean Index of Economic Freedom we can see that both

countries Index lies below the world average. Both countries have corruption as one of countries major challenges.

According to the Word Bank data Moldova received in foreign aid 473 million US dollars in 2014 and 464 millions in 2015. Although Moldova receives significant amounts of foreign aid, it remains one of the poorest countries in Europe.

Most Moldovans see corruption as one of the country's major challenges. According to the Index of economic freedom "corruption is systemic and deeply embedded in Moldova's public institutions, especially in law enforcement, the judicial system, public service, political parties, the educational system, and legislature, Bureaucracy and lack of transparency makes the formation and operation of private enterprises difficult. The weak rule of law and a lack of progress in implementing open-market policies prevent broader and more dynamic economic development. Economic performance is far below potential. " (IEF, 2015)

In the next section, I will show in more details how weak institutions in Moldova make it vulnerable to grabbing, which may lead to a resource curse from foreign aid.

## 5. Foreign aid in Moldova - a curse or aid-institutions paradox?

The Republic of Moldova (Moldova) has benefited from foreign assistance since its independence in 1991, but is still the poorest country in Europe. More than one-fifth of the country's population lives in poverty. More than one-quarter of Moldova's population works abroad. This economic situation is a consequence of the foreign aid curse or aid-institutions paradox? Let's study Moldova's case to try to understand the relationship between foreign aid, rent-seeking and quality of institutions.



### 5.1. Poor and vulnerable

Moldova is situated between the rivers Dniester and Prut, an area formerly known as Bessarabia. This territory was annexed by the USSR in 1940 following the carve-up of Romania in the Ribbentrop-Molotov pact between Hitler's Germany and Stalin's USSR. As a result Moldova was ultimately incorporated into the USSR as the Soviet Socialist Republic of Moldova (SSR Moldova). On 27 August 1991, the former SSR Moldova declared its independence from the Soviet Union under the constitutional name of the Republic of Moldova. With a moderate climate and good farmland, Moldova's economy relies heavily on its agriculture sector, featuring fruits, vegetables, wine, and tobacco. Although the manufacturing sector, specialized in textiles and leather products, has been recovering, Moldova's economy is characterized by the large agricultural sector which accounted for almost one fifth of GDP in 2004. Moldova's agricultural is actually in a zone at high risk of

both frosts and droughts. Hothouse farming was one of the most important areas of Moldova's farm sector during soviet times but it was based on access to cheap energy. Now it is no longer profitable or competitive because of high energy costs. The canning industry, which was another well-developed branch of Moldova's agricultural sector, was not upgraded in a timely manner and has lost its competitiveness on both external and domestic markets. Agricultural and food-processing products accounted for 54% of all exports in 2004. With few natural energy resources, Moldova imports almost all of its energy supplies from Russia and Ukraine. Moldova's dependence on Russian energy is underscored by a growing \$5 billion debt to Russian natural gas supplier Gazprom, largely the result of unreimbursed natural gas consumption in the separatist Transnistria region. In August 2013, work began on a new pipeline between Moldova and Romania that may eventually break Russia's monopoly on Moldova's gas supplies. Over the longer term, Moldova's economy remains vulnerable to political uncertainty, weak administrative capacity, vested bureaucratic interests, corruption, higher fuel prices, Russian pressure, and the illegal separatist regime in Moldova's Transnistria region. A 2007 embargo on imports of Moldovan wine to Russia was a serious shock to the country's farm sector and its overall economy. However, it pushed Moldova's vintners to become more competitive by setting much higher standards of quality control. The main obstacle to developing Moldova's agriculture remains its almost complete lack of compliance with EU standards and norms. Despite a generally favorable trade regime, the EU market remains closed to Moldovan farm products, while the domestic market is too small to keep agricultural production at an economically sound level.

## **5.2. Emigration and remittances**

Substantial emigration (close to 400 000 Moldovans were estimated to be working abroad in November 2004, around one million in 2010) has resulted in a strong and growing influx of worker's remittances – four times and a half since 2001. According to official NBM statistics, the overall level in 2005 is estimated at US\$ 900 million which represents close to 30% of Moldovan GDP. Remittances are thus a key feature of economic development and social life and have contributed directly to reducing poverty. Remittances are also a major revenue item in Moldova's current account; their growth compensates – and makes possible – huge trade deficits run by Moldova. In 2006-2007, remittances also became a source of investment growth, primarily into housing. Moldova's imports are now more than double its exports and

the trade deficit was close to 40% of GDP in 2005. Understandably, economic growth and public finances are at the same time highly vulnerable due to their heavy reliance on remittances to cut trade deficits.

### 5.3 Growth

Over the past five years, the Republic of Moldova's GNP growth has averaged around 5-6 %, being driven mainly by compensatory growth in agriculture, but also by revival in consumption fuelled by remittances and wage growth. In 2014, GDP growth rate was 4.6 percent, by 4.8 percentage points lower than in 2013, mainly due to a lower contribution from the increased agricultural production and an unfavorable external climate, which has resulted in the economic activity deterioration of the major trading partners and the embargoes imposed by the Russian Federation.

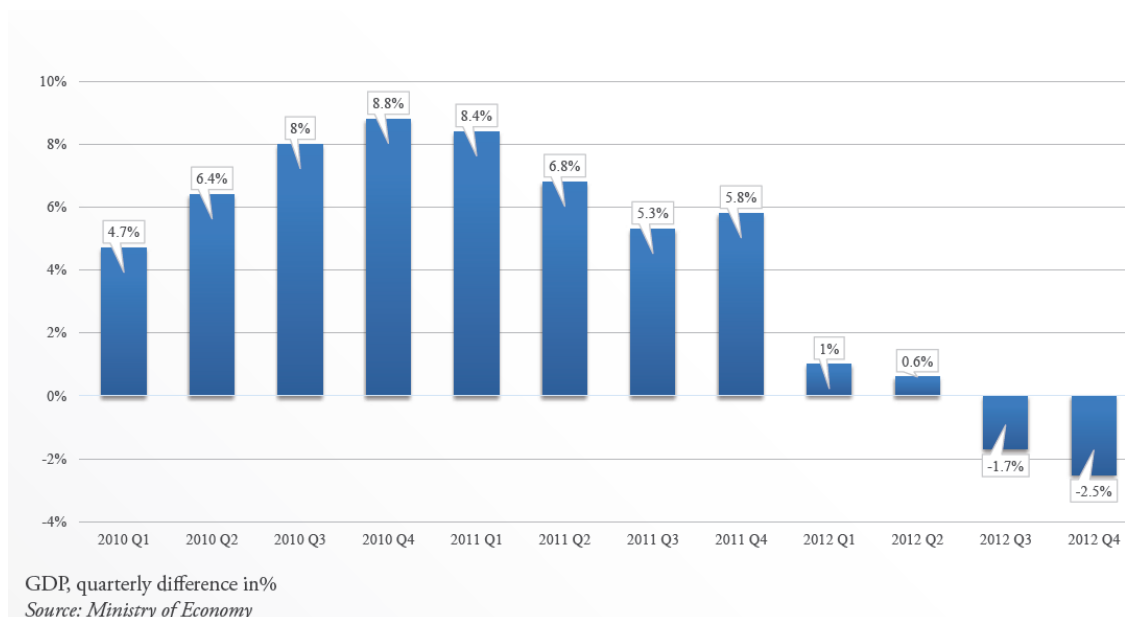
**Figure 5.1. GDP Growth in the Republic of Moldova**

**GDP Growth (Constant Prices)<sup>[19]</sup>**

<b>Year</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014e</b>
<i>Real GDP Growth</i>	7.4%	7.5%	4.8%	3.0%	7.8%	-6.0%	7.1%	6.8%	-0.73%	9.4%	4.6%

Source: World Bank

**Figure 5.2. Moldova's GDP quarterly difference in %**



Over recent years, Moldova's economy experienced several shocks, including sharp price rises on imported energy in 2005 and a ban on Moldovan wines in the Russian Federation. In other words, the country faced the global financial crisis already weakened by economic blows, as GDP growth had declined from 6-7% to 3-4% in 2007. The economic growth in 2014 lost velocity and may have become negative in early 2015. Consumers became more cautious with their savings, as a result consumption had declined. Exporters are affected by the economic problems of Moldova's main trade partners and went down. Moldova's economic growth is primarily consumption-driven, with decline in consumption GDP growth also slows down. Investment rates have remained very low. (World Development Indicators database, World Bank).

**Figure 5.3. GDP growth in the Republic of Moldova.**

	2012	2013	2014(e)	2015(p)
GDP growth (%)	-0.7	9.4	4.6	-1.0

Source: World Bank

## 5.4. Employment

Although Moldovan structural reforms have resulted in the closure of enterprises, unemployment has remained relatively stable over the last five years, around 8% (6.6% in 2005) according to World Bank estimates. Although the lower numbers may seem comforting, they conceal a rather worrying reality: 25% of the active population has left the Republic of Moldova, and 50% of those remaining have turned to agriculture for sustenance. The average monthly wage of 4000 lei (MOLDSTAT), or approximately US\$197, is simply not sufficient to live on. This helps explain the existence and role of the Republic of Moldova's large shadow economy that, simply put, accounts for a significant quantity of hidden income. The economic growth of the last years did not translate into higher employment. The Moldovan economy is failing to generate a sufficient number of jobs. “Dutch disease”—the widespread export of labor—is everywhere in Moldova. Of its 3.5 million population, nearly one million in 2010 are migrants working abroad, representing the most educated and skilled part of the workforce. This seriously undermines Moldova's economic potential.

## **5.5. Fiscal policy**

Fiscal conditions in the Republic of Moldova have also posed a challenge. Although the Republic of Moldova's GDP fell steadily after independence, government expenditures did not. The Republic of Moldova's inevitable budget deficit, in turn, eventually threw state finances into chaos. Starting in 1997, the government implemented more sound fiscal policies to reduce government expenditures. It slashed direct and indirect subsidies to a range of sectors and borrowers (mainly state-owned loss-making enterprises), but it also reduced public outlays on health, education and social protection. The debt situation has improved, but at the expense of public access to critical services. Because tax evasion is widespread, there is an ever-present risk of fiscal crisis; and the state's capacity to squeeze the social sector has its limits.

## **5.6. Debt**

The Republic of Moldova's external debt in 2006 stood at US\$2.5 billion. The Republic of Moldova is primarily indebted to international financial institutions (IFIs), but Russia and other Paris Club members are also important creditors. In 2006, after signing an arrangement of US\$118.2 million with the IMF under the Poverty Reduction and Growth Facility, the Republic of Moldova was able to negotiate a US\$150 million debt rescheduling with the Paris Club creditors. Although debt rescheduling has eased fiscal pressures, the Republic of Moldova's huge debt continues to loom over the national economy.

## **5.7. Foreign aid**

International programs working in Moldova have two main goals: to achieve sustainable economic growth in order to reduce the gap in quality of life between Moldova and EU countries; and to support the poorest Moldovans and organize relief services for them, to reduce social inequality and to increase social welfare.

Over the last decade, the number of donors to Moldova has increased to over 30, but the only providers of direct budget support is EU and World Bank.

The external assistance disbursements to Moldova in 2012 amounted to 465 million Euros ( State Chancellery report), i.e. about 8,26% of GDP or about 21.65% of the income to the National Public Budget, and about two fifths of the net remittances. Government Decision No. 12 dated 19 January 2010 the State Chancellery is the National Aid Coordination Authority in the Republic of Moldova and is responsible, at national level, for the coordination of programming, monitoring and evaluation of the external assistance delivered to Moldova by the development partners.

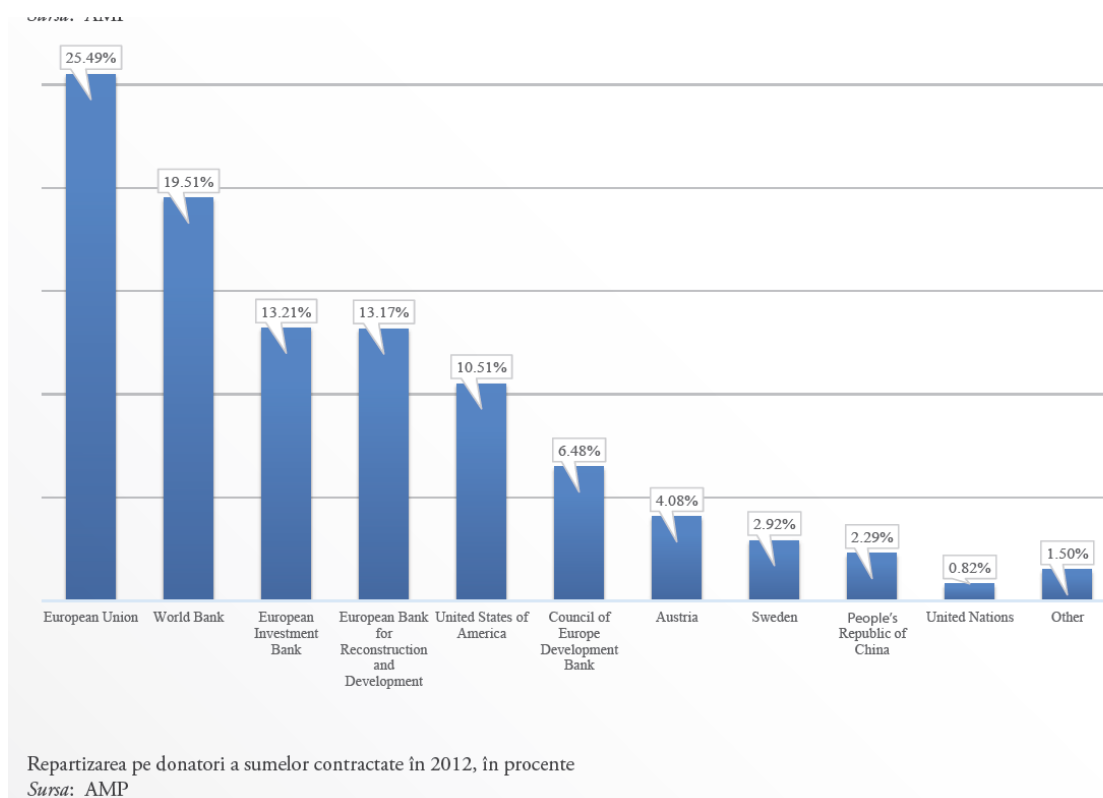
The EU budget support assistance in 2007-2013 covers the following sectors: social, health, water and sanitation, rural development, energy, justice, mobility and security – visa liberalization. The World bank's budget support provided to Moldova in 2012 ( 30 mln. USD) targeting the reforms within economic growth and poverty reduction.



The sector budget support programs, implemented in 2012 the EU financial support, targeted the health, water and sanitation sectors, economic stimulation in the rural areas and the energy sector.

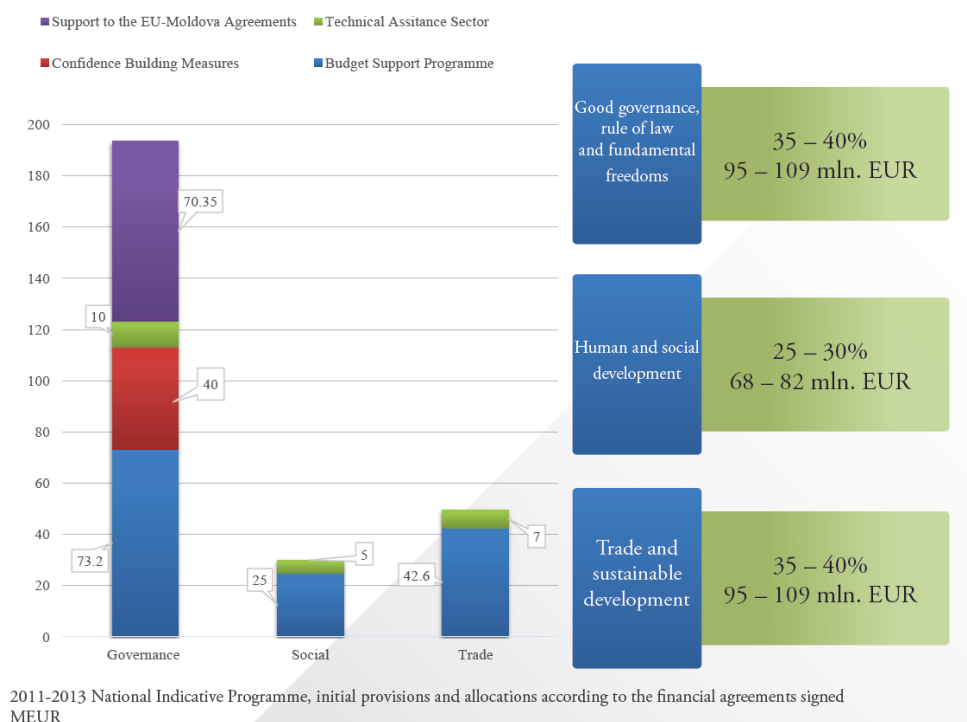
The European Union is the largest donor for Moldova. Other important donors are European Bank for Reconstruction and Development( EBRD), European Investment Bank (EIB), World Bank (WB), The Government of the United States of America, UN, the Kingdom of Sweden, Austria, the Swiss Confederation and the German Federal Republic.

**Figure 5.4. Foreign aid per donor provided in 2012, in percents**



Source: Aid Management Platform public portal of the Government of Moldova

**Figure 5.5. Allocation of the foreign aid funds in Moldova, 2011-2013**



Source: Aid Management Platform public portal of the Government of Moldova

Throughout 2004-2011, the Republic of Moldova has benefited from external assistance of around 2.99 billion USD, 2.10 billion USD of which are grants( 71%) and 888,8 million USD( 29%) loans. The share of aid disbursed in 2012 in GDP is about 8,26% of GDP and 21,65% of the current National Public Budget. About 109,4 million Euros ( 148.8 million USD) were received in the forms of grants and 97,1 million Euros ( 132,07 million USD) in the form of loans( EBRD, EIB and WB) which represents a grant – loan parity of 53% and 47% of aid received in 2012 ( State Chancellery 2013).

**Figure 5.6. Report of External Assistant to the Republic of Moldova in 2012**

Year	Other Grants mln USD	Gross Loans mln USD
2004	118.97	25.86
2005	173.14	32.23
2006	168.6	110.04
2007	211.77	90.64
2008	238.08	79.82
2009	246.12	28.7
2010	316.16	204.26
2011	310.81	155.03
2012	319.88	162.27
<b>Total</b>	<b>2103.53</b>	<b>888.85</b>
<b>Grants and loans total</b>	<b>2992.38</b>	

*Source: WDI, State Chancellery (report of external assistance 2012), own calculations*

The distribution between the years is irregular but shows a clear tendency of foreign aid flows to grow over time. The periods 2005-2007 was marked by the increase of the volume of aid determined by growing assistance from EU and international financial institutions (IMF, WB)

**Figure 5.7. Moldova: External Grants and Loans to the Budget, 2000-2010**

(Millions of U.S. dollars unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total grants and loans in the budget	62.8	42.7	47.5	29.5	32.9	23.5	72.1	122.6	144.5	326.5	352.3
Total grants	12.0	11.6	9.6	5.2	10.2	0.0	24.0	63.1	101.4	99.2	140.3
Budget grants	10.7	10.3	5.4	0.1	0.0	0.0	4.7	45.1	62.3	69.8	106.7
Projects grants	1.4	1.3	4.2	5.2	10.2	0.0	19.3	18.0	39.1	29.4	33.6
Total loans	50.8	31.1	37.9	24.2	22.8	23.5	48.1	59.5	43.2	227.4	212.0
Excluding IMF 1/	50.8	31.1	37.9	24.2	22.8	23.5	48.1	59.5	43.2	41.1	90.3
Budget support loans	n.a	n.a	n.a	n.a	n.a	0.0	0.0	10.0	9.8	0.0	44.0
Project loans	n.a	n.a	n.a	n.a	n.a	23.5	48.1	49.5	33.3	41.1	46.3

(Percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total grants and loans in the budget	4.9	2.9	2.9	1.5	1.3	0.8	2.1	2.8	2.4	6.0	6.1
Total grants	0.9	0.8	0.6	0.3	0.4	0.0	0.7	1.4	1.7	1.8	2.4
Budget grants	0.8	0.7	0.3	0.0	0.0	0.0	0.1	1.0	1.0	1.3	1.8
Projects grants	0.1	0.1	0.3	0.3	0.4	0.0	0.6	0.4	0.6	0.5	0.6
Total loans	3.9	2.1	2.3	1.2	0.9	0.8	1.4	1.4	0.7	4.2	3.6
Excluding IMF 1/	3.9	2.1	2.3	1.2	0.9	0.8	1.4	1.4	0.7	0.8	1.6
Budget support loans	n.a	n.a	n.a	n.a	n.a	0.0	0.0	0.2	0.2	0.0	0.8
Project loans	n.a	n.a	n.a	n.a	n.a	0.8	1.4	1.1	0.6	0.8	0.8

Sources: Moldovan authorities; and IMF staff estimates.

1/ 2009 includes SDR allocations.

Source: Driton Qehaja *Fiscal Policy Response to External Crises: The Case of Moldova 1998-2010*, IMF working paper 2012

It seems like Moldova has all the necessary tools to actually succeed with economical development – willingness of local population and government to implement reforms, support from international organizations through both loans and foreign aid, economy which showed positive development in the period between 2004 - 2008. Why then it still one of the poorest countries in Europe? Why Moldova fails to succeed with its reforms implementation?

One of the reasons is the lack of institutional capacity to implement reforms and sustain results, even when political will is present. There is often powerful bureaucratic resistance to fundamental reforms due to completely unreformed soviet organizational principles and structures in public administrations. A soviet-style administration is incapable of operating in a democratic political system and market economy, especially when it comes to implementing reforms. Not only the institutional base, but also management principles and human resource policies in the Government need to be brought in line with EU standards. Moldova's public administration currently suffers from typical soviet symptoms: an unreasonable number of employees with generally low competence and poor pay. Blue collar workers in Moldova tend to be much better paid than most public servants.

Another reason is the conflict of interests within the government. Government and the leaders of the Alliance tend to pursue different goals. Those more interested in enhancing their political capital can be called the reformers, as they are interested in changes. "Others can be called rent-seekers, as their interest lies in maintaining status quo or undertaking only cosmetic changes instead of serious reforms. Their goal is to take over from the previous team in power and gain access to resource flows"( Economic reforms in Moldova: Avoiding the Ukrainian trap, 2012 ).

## **5.8. Moldova – grabbers' heaven? The robbery of 1 billion USD**

Foreign aid funds create incentives for rent-seeking among Moldova's elites who have the access to these funds. A good example of how easy it is to grab in Moldova is the disappearance of 1 billion USD, equivalent to 12% of Moldova's GDP, from 3 of Moldova's largest banks in November 2014. The National Bank of Moldova engaged a leading financial investigation consultancy called Kroll to investigate the transactions in the three banks involved, Banca de Economii S.A., Banca Sociala S.A. and Unibank S.A. The Kroll-report (2015) was first confidential, but released after thousands of people protested in the country's capital in May, 2015. The Kroll-report identifies 28-year-old Ilan Shor as the mastermind behind the robbery. Shor is one of the richest people in the country. His father accumulated much of the family's wealth by setting up Moldova's first duty-free shops. The report said

Shor and his associates worked together in 2012 to buy a controlling stake in three Moldovan banks and then gradually increased the banks' liquidity through a series of complex transactions involving loans being passed between the three banks and foreign entities. The three banks then issued multimillion-dollar loans to companies that Shor either controlled or was connected to. Over \$767 million was transferred from the banks in just three days through complex transactions. The central bank estimates the total loss from the scheme could reach \$1 billion. A large portion of this money was transferred to offshore entities connected to Shor. Some of the money was then deposited into Latvian bank accounts under the names of various foreigners.

The Kroll report highlights the difficulties of the investigation, because internal reports and documentation from the three banks were lost. Important electronic data was also deleted.

Kroll report refers to unusual events that took place on the 26 November 2014, at the same time as new loans were issued in Banca Sociala. From the Kroll report: “For unexplained reasons, loan exposure was reversed out of Banca de Economii (BEM) and the existing balances held on deposit between BEM and Russian banks cleared down. A complex series of transactions eventually resulted in new loans to the value of MDL 13.7 billion being issued by BS to five Moldovan entities, who transferred the funds on to UK registered Limited Partnerships with accounts at Privatbank in Latvia

The above loans were sold to a UK registered shell company, for nominal value plus accrued interest of MDL 4,7 billion, to be paid in annual installments by November 2019. As a result, the receivable remains outstanding in BS's balance sheet.

Orders were given by management of the banks to archive loan documentation relating to the suspicious transactions with entities deemed part of the Shor Group. These were collected by a vehicle provided by Klassica Force SRL, which was subsequently stolen and found burned out, whilst containing all relevant loan documentation

Management of BEM attempted unsuccessfully to reverse the original Roseu session agreement, restoring the un-performing loans to BUM and returning the cash originally paid by Roseau”. (Kroll, 2015)

Kroll report states that 12 sacks with documents held by these three banks disappeared under “suspicious circumstances only a few days prior to BEM being placed under special administration on 27 November 2014”. An internal investigation conducted by BEM in December 2014 established that on 26 November 2014 the acting president of BEM, Viorel Birca issued an internal order requiring activating of specific document related to the placement and receipts of certain loans. The order was communicated to relevant people and 12 sacks of files were transferred to Viorel Birca’s office. A vehicle was ordered from the Klassica Force SRL, a security company which is controlled again by Ilan Shor. All the 12 sacks were loaded into the vehicle on 26 November and according to the driver the documents would be transported to the archive the following day, on the 27<sup>th</sup>, the vehicle would be held in a secure garage overnight. The following day, Klassica Force SRL informed BEM that the vehicle had been stolen and found burned out, a fact confirmed by Moldavian police report issued in 1 December 2014. (Kroll, 2015).

Kroll reports states that the” events of the latter half of 2014, and particular November 2014, show a coordinated effort involving all three banks working together to extract as much loan finance as possible from the banks without any obvious business rationale for the increased exposure”. Kroll’s investigations point out that majority of top management of all their banks who were coordinating November events together with Shor are either relatives, family members or good, old friends to Shor.

The report said a full forensic investigation is needed to identify other potential beneficiaries and recover the funds. Shor has been charged with corruption and placed under house arrest, but not for a long time. Shor was released from house arrest on 23 May, having agreed to cooperate with investigators. At the 01 of July 2015 Ilan Shor has been officially elected as the “primar la Orhei” or Mayor of Orhei, one of the middle-sized cities in Moldova.

Ilan Shor denies responsibility for the financial catastrophe.” The Kroll report - based on National Bank records - proves nothing, he says, and contains no documents "apart from cuttings from various articles".([www.bbc.com](http://www.bbc.com), The great Moldovan bank robbery, 18.june 2015).

## **5.9. The repercussions of robbery**

The robbery caused a great panic in Moldova. People are still protesting in the streets of Chisinau and demand an investigation on missing money from the government. The protesters are calling on the government to resign and want an end to corruption. Thousands are holding Moldovan and EU flags and chanting "Victory!" and "Go!". ([www.bbc.com](http://www.bbc.com), Moldova anger grows over banking scandal, September 14<sup>th</sup>, 2015).

It is also obvious that such an incident continues to have negative effects for the economy. The country may run out of funds to pay the public servants, retired ones and employees. Some economists claim that an economic default is what we should expect in Moldova, if World Bank or IMF don't intervene. Such an incident may have eroded any hopes and dreams of Moldova's aspirations to become a part of EU. As a consequence of November events national currency lost 42% of its value during 2 months.

In order to keep economic stability in the country the government chooses to save the three banks, and so they granted them emergency loans. The volume of the guarantees is significant, if compared with the size of the Moldovan economy (about 9% of GDP and 34% of the state budget revenues). Therefore, public debt as a percentage of GDP will increase from 32% in 2014 to 48% in 2015 and 51% in 2016.<sup>1</sup> With a budget deficit, current account deficit, low level of official reserve assets and risks to the national currency, a higher level of indebtedness fuels the country risk. It will generate a significant fiscal shock that may last 10 years.

IMF and World Bank have suspended programmes with Moldova, and the EU is considering doing the same. World Bank country manager Alex Kremer said at the end of June that : "We are advising the authorities that the three banks ... should be liquidated." He said trying to nationalise or recapitalise the banks would risk wasting more taxpayers' money.

After the robbery was known, World Bank has blocked assistance of 45 mln.dollars for Republic of Moldova, money which should of support the 2015 budget. According to Alex Kremer, World Bank Country Manager for Moldova " World Bank cannot make such a large payment into the Government budget until Moldova resolve banking sector problems. It would be illogical and irresponsible for the World Bank to transfer our shareholders' money into the budget through the front door while there is a risk of even larger sums of public

money being lost out of the back door through fraud and corruption in the banking sector. This has been the World Bank's position since the banking sector issues emerged in early 2014." (2015, Jurnal md, Moldovans Deserve a Clean Economy).

The Nobel Prize winner in economics in 2015, Angus Deaton who is concerned about the importance of institutions in the aid recipient country, means that foreign aid reduces authorities' incentives in recipient country to create good, including institutions. Such authorities do not need any contact with their citizens, no national assembly, not a taxation system ( Dagbladet). This is exactly what is happening in Moldova, where the government after November events denies to meet and talk to the thousands of protestants in the streets of Chisinau.

### **5.10. Low quality of governance**

Along with rent-seeking, corruption is one of the most significant impediments for the reform and for the economic recovery of the Republic of Moldova. This has been recognized by both, the Government of Moldova, as well as international organizations collaborating with Moldova, including the World Bank, UNDP, IMF, and Transparency International.

According to evaluations by Transparency International, Moldova is placed in a group of countries with a high index of corruption. On a descending scale of 10 to 0 (with 0 representing total corruption and 10 total lack of it), Moldova scored 2.6 in 2000. According to this scale, in 2000 Moldova is placed on the 76th place, after the Ivory Coast, and followed by the Ukraine and Venezuela.

In a joint study by the EBRD and the World Bank an opinion poll of about 3000 managers from 20 countries in transition was carried out. Its results show that Moldova held the 15<sup>th</sup> place from the top in terms of microeconomic governance (the index being equal to 0.52 out of a maximum of 3.0), the last place for the quality of macroeconomic governance (the index being 0.35), the last place for infrastructure (index being 1.42), and the penultimate place with regards to law enforcement (the index being 1.1).



According to the aggregated quality of governance index, Moldova held the last place, with an index of 0.82. About 75 % of Moldovan firms mentioned that the legal system does not protect

Their property rights. Moldovan managers of enterprises spend 17 % of their total working time with public officials. This is the top figure amongst all countries in transition.

**Figure 5.8. Quality of governance index**

	Micro-measures	Macro-measures	Infrastructure	Law and order
Hungary	0.92	1.72	2.42	2.34
Slovenia	1.17	1.73	2.26	2.23
Estonia	1.25	1.74	2.38	2.17
Uzbekistan	1.4	1.44	2.11	2.16
Armenia	0.55	1.15	2.21	2.32
Poland	0.96	1.53	2.37	1.82
Slovak Republic	0.88	1.68	2.11	1.7
Czech Republic	0.8	1.35	1.57	1.97
Belarus	0.67	0.77	2.18	2.25
Lithuania	0.69	1.7	2.19	1.48
Azerbaijan	1.02	1.59	1.73	1.56
Croatia	0.67	1.18	2.13	1.62
Bulgaria	0.9	1.25	1.77	1.49
Kazakhstan	0.75	0.72	1.85	1.68
Georgia	0.67	0.93	1.78	1.47
Ukraine	0.34	0.77	1.76	1.68
Russia	0.47	0.65	1.91	1.54
Romania	0.45	0.6	1.49	1.48
Kyrgyzstan	0.46	0.48	1.85	0.98
Moldova	0.52	0.35	1.42	1.1

*Source: EBRD, Transition Report, 1999*

At the same time Moldova was ranked 81<sup>st</sup> out of 183 economies in the Doing Business Indicator in 2012 and 132<sup>nd</sup> out of 155 countries in the 2012 Logistics Performance Index. The Doing Business project provides objective measures of business regulations and their enforcement across 189 economies and selected cities at the sub national and regional level. Doing Business encourages economies to compete towards more efficient regulation; offers measurable benchmarks for reform; and serves as a resource for academics, journalists, private sector researchers and others interested in the business climate of each economy. Being ranked on the 81 place means that it is not so easy to do business and start and operate in the regulatory environment of Moldova. The Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they

face in their performance on trade logistics and what they can do to improve their performance.

### 5.11. Public opinion.

Along with this above mentioned indexes public opinion reflects the unfavorable economic and social situation in Moldova. Already in 2013 the public opinion was negative about economic situation to the Republic of Moldova. If we look at the poll that was conducted during the period 28<sup>th</sup> of March - 13<sup>th</sup> of April 2013 which was commissioned by the Institute for Public Policy (IPP), with the financial support of SOROS Foundation Moldova we can find evidence of disappointment among the populations of Moldova. The pool from 2013 („Barometer of Public Opinion– 2014”). ) is on a sample of 1 115 people from 76 communities, representative for the adult population of the Republic of Moldova (except its Transdnistrian area), the maximal sampling error is  $\pm 3\%$ . From these 1115 people :

- 68% of the population consider that the Republic of Moldova is moving towards a *wrong direction*. The share of respondents who expressed such an opinion has not changed compared to the previous poll. This opinion is mostly shared by the respondents of non-Moldovan nationality, as well as by the ones with a low and an average income.
- In this context, it should be noted that the largest share of population (over 3/4) remains discontent with Government policies in the major fields of social life: *salaries* (91%), *employment* (89%), *living standards* (88%), *pensions* (87%), *fighting against corruption* (86%). In general, the degree of discontentment has increased in all areas compared to two years ago. It is also worth being mentioned that the people's discontentment with the measures aimed at *settlement of the Transdnistrian conflict* is more pronounced (86% - an increase by 6% compared to November 2013) in the context of the present events in Ukraine.
- 55% of the population are not content with the present economic situation in the country. 45% of respondents consider that the present economic situation *has not changed* compared to the previous year, while 32% of them consider that the situation *has worsened*, this share being by 12% lower than at the previous poll. One

respondent out of five perceives some improvements in the present economic situation, these are mostly the inhabitants of the rural areas, young people, people with a high level of income and the population of Moldovan nationality.

- With regard to the prospects of the economy in the coming year, the share of optimistic respondents amounts to 25%, while 36% of the sample do not expect any changes. 25% of the population are doubtful about the future, considering that the economic situation will worsen next year.
- According to the respondents, the major measures intended to boost the social-economic situation in the country are traditionally targeted at *development of the economic sector* – developing the industry (42%), encouraging investments (26%), supporting small business in farming sector (31), as well as at *improving the tools for law enforcement* (40%) and *fighting against corruption* (33%).
- The level of people's trust in the major institutions of the State shows a significant increase (compared to the previous poll): Government – from 16% to 28%, Parliament – from 14% to 22%, President – from 16% to 25%, *but the level of trust is constant compared to the period under consideration of the year 2012*. Confusing – the trust has increased from the previous poll (which was when?) but is unchanged from year 2012 The lowest trust was traditionally expressed in relation to *political parties* (19% of respondents expressed very much trust or some trust).
- 3 out of 4 respondents consider that the people's will does not rule in the Republic of Moldova, while 2 out of 3 respondents think that the elections are not free and fair in our country.

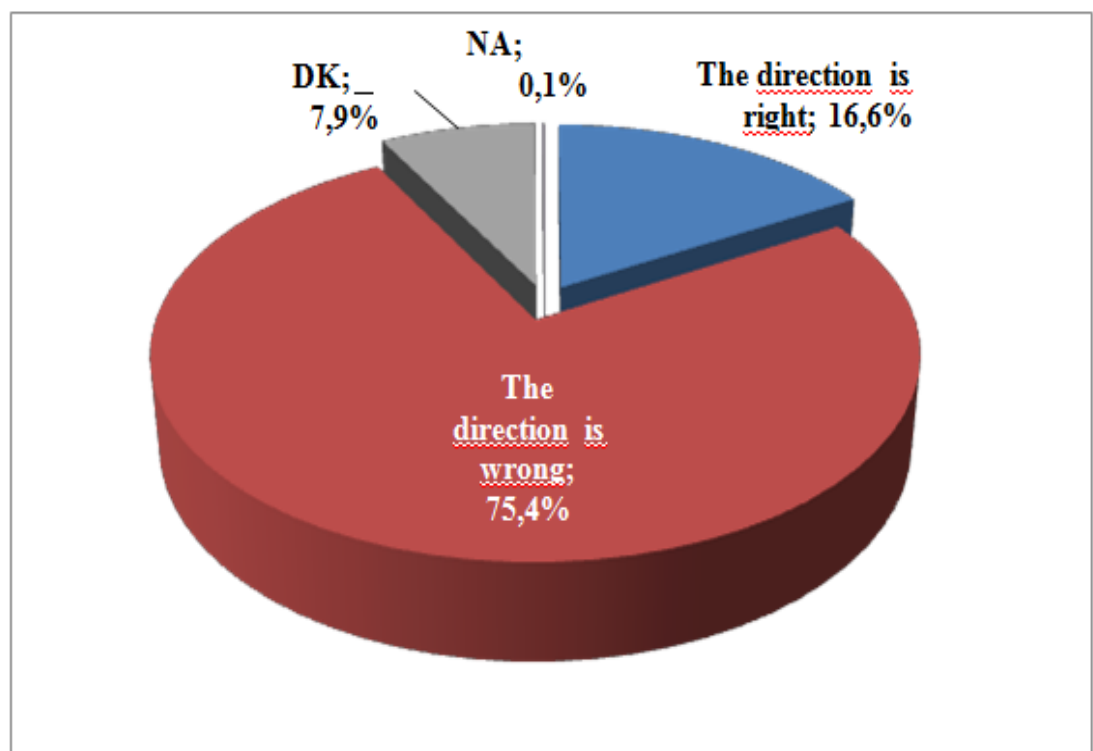
Public opinion has not been better in 2015. According to the „Barometer of Public Opinion–2015”.

- 75,4 % consider that the Republic of Moldova is moving in a *wrong direction*.

Figure 5.9. Distribution of responses to the question: Is Moldova moving towards a right or a wrong direction?

BOP – aprilie 2015

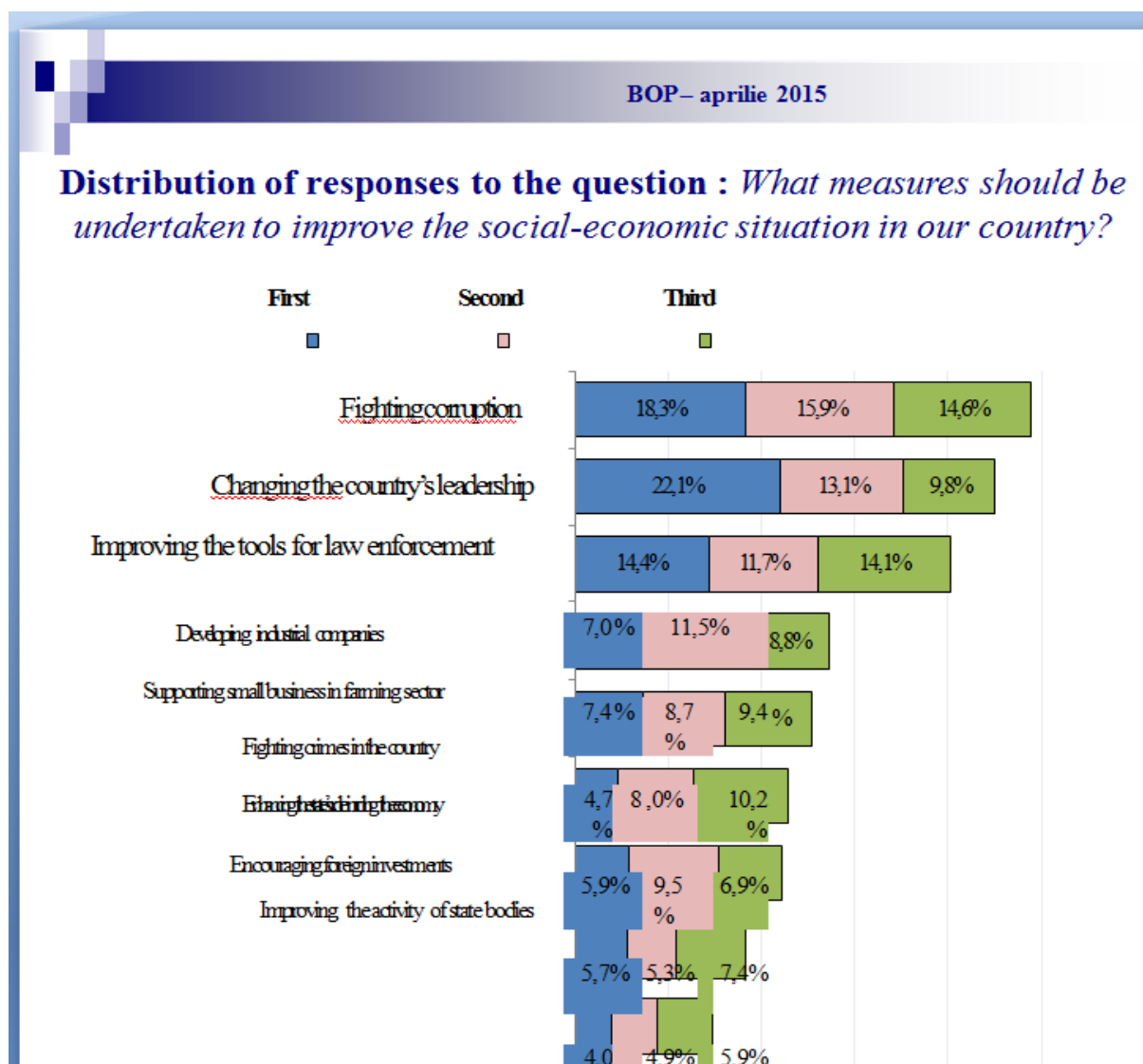
Distribution of responses to the question : Is our country moving towards a right or a wrong direction?



Source: Barometer of Public Opinion

- 22,1% of Moldova's population do not trust their government and think that changing the country's leadership would improve the social-economic situation in our country.

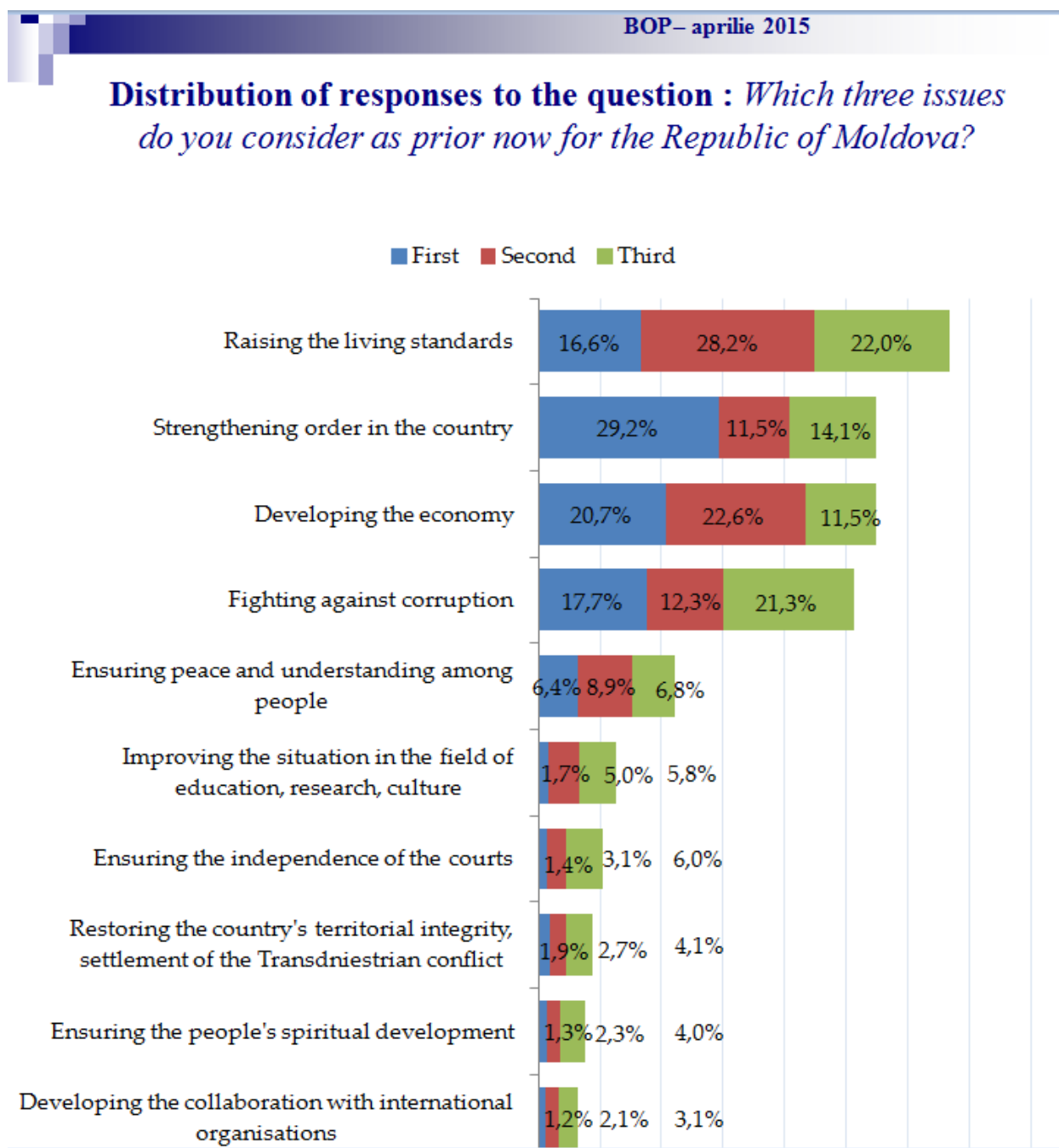
**Figure 5.10. Distribution of responses to the question: What measures should be undertaken to improve the social-economic situation in Moldova?**



Source: Barometer of Public Opinion

- At the same time 29,2 % consider strengthening order in the country as prior issue for Republic of Moldova right now.

**Figure 5.11. Distribution of responses to the question: Which three issues do you consider as prior now for the Republic of Moldova?**



Source: Barometer of Public Opinion

## 6. Conclusions

Most foreign aid is designed to meet one or more of four broad economic and development objectives: (1) to stimulate economic growth through building infrastructure, supporting productive sectors such as agriculture, or bringing new ideas and technologies, (2) to strengthen education, health, environmental, or political systems, (3) to support subsistence consumption of food and other commodities, especially during relief operations or humanitarian crises, or (4) to help stabilize an economy following economic shocks. But foreign aid does not always achieve these goals. On the contrary, in some cases it has negative effects on the social and economical situation, a so called aid-curse. The key to avoid an aid curse and achieve economic development is in the quality of public institutions. Good institutions promote democratic reforms and lead the country to prosperity and good social and economical development.

With bad quality public institutions, foreign aid can be a source of rent-seeking, corruption, crimes and can keep bad governments in power for too long. Foreign aid can undermine incentives for saving, tax collection, and private sector production and as a result slow down countries economic growth.

To cite this year's winner of the Nobel Prize in economics, Angus Deaton :“The key to understanding why aid does not work lies in the relationship between aid and politics. Political and legal institutions play a central role in creating the environment needed to nurture prosperity and economic growth. Foreign aid, especially when there is a lot of it, affects how institutions function and how they change. Politics has often choked off economic growth, and even in the world before aid, there were good and bad political systems. But large inflows of foreign aid change local politics for the worse and undercut the institutions needed to foster long-run growth. Governments that receive most of their revenues from abroad are relieved of the need to raise taxes at home, and so do not need to justify their activities to their own populations. Aid thus undermines democracy and civic participation, a direct loss over and above the losses that come from undermining economic development. These harms of aid need to be balanced against the good that aid does, whether that's educating children who

would not otherwise have gone to school or saving the lives of those who would otherwise have died. But we cannot look only at the direct benefits, and we need to understand that, in the long run, schools and clinics cannot be run from outside the country. Good government requires a contract between the state and the people, and aid undermines such contracts. ”  
(Foreign Policy article, [The Great Escape](#), 2013)



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